U.S. COMMODITY FUTURES TRADING COMMISSION

Three Lafayette Centre 1155 21st Greet, NW, Washington, DC 20581 Telephone: (202) 418-5000 Facsimile: (202) 418-5521 S TRADIAC COMMISSION IN THE PROPERTY OF THE PR

September 11, 1996

Mr. Brian Soutiere President Bnergy Exchange Inc. 1950,801 - 6th Avenue S.W. Calgary, Alberta T2P 3W2 PUBLIC RECORD
PUBLIC RECORD

Re: Electronic Natural Gas Trading System

Dear Mr. Soutiere:

This is in response to your letter dated December 20, 1994, and subsequent correspondence, in which you request confirmation from the Off-Exchange Task Force ("OETF") that the OETF will not recommend that the Commodity Futures Trading Commission ("Commission") initiate enforcement proceedings against Energy Exchange Inc. ("EEI"), Enerchange L.L.C. ("Enerchange"), or QuickTrade L.L.C. ("QuickTrade") if such firms commence operation of an electronic system for trading physical natural gas in the United States. Based upon the representations made in your December 20, 1994 letter, as supplemented by additional correspondence, telephone conversations, and your presentation to the OETF, the OETF understands the facts to be as set forth below.

EEI is a wholly-owned subsidiary of Direct Energy Marketing Limited ("DEML"), a natural gas marketing company. Both EEI and DEML are incorporated under the Business Corporation Act of Alberta, Canada and are based in Calgary, Alberta. Since January of 1994 EEI has operated in Canada an automated natural gas trading system with delivery at hubs in the Alberta market. EEI represents that the Alberta-based system is a physical delivery trading system which mirrors local natural gas cash market practices. EEI further represents that traders on the Alberta system are commercial participants of the natural gas market.

On August 8, 1995, BEI signed a letter of intent with Enerchange to develop and operate an electronic natural gas trading system ("System") which will offer delivery at several United States-based natural gas hub locations as well as provide System subscribers with access to the existing Alberta-based system. The System commenced operation in the United

States on January 8, 1996, and is operated by QuickTrade which is owned 50 percent by EEI and 50 percent by Enerchange. QuickTrade is based in Houston, Texas.

The System initially provides for delivery at the Chicago Hub. QuickTrade plans to expand delivery locations to include the Ellisburg-Leidy Northeast Hub in Pennsylvania and the California Energy Hub in southern California as well as several gulf coast pipelines in the near future. Enerchange administers the operations of each of these hubs.

System subscribers are classified into one of two separate categories: View-Only Subscribers and Active-Status Subscribers. View-Only Subscribers are permitted to access the System for the limited purpose of obtaining current price information only. View-Only Subscribers are not able to execute trades on the System. Active-Status Subscribers may enter bids and offers to buy or sell natural gas, or alternatively, accept existing bids or offers. Subscribers may access the System via their personal computer and modem on a twenty-four hour-per-day, seven day-perweek basis. All trading is performed on an anonymous basis.

QuickTrade represents that the System is a physical delivery trading system. Participation on the System as an Active-Status Subscriber is restricted by QuickTrade to participants of the natural gas market who have valid service or transportation agreements in place with pipeline operators who will transport natural gas to or from the designated delivery points. QuickTrade represents that natural gas producers, gas end users, and gas marketers are authorized to trade on the System. QuickTrade also represents that individual speculators, commodity pools, passive collective investment vehicles, and other noncommercial entities are not now, nor are anticipated to be, Active-Status subscribers.

^{1/ (...}continued)
and services in North America and the United Kingdom), NICOR Inc.
(a holding company whose principal business is Northern Illinois
Gas), Pacific Enterprises (a Los Angeles, California-based utility
holding company primarily engaged in supplying natural gas
throughout most of southern and portions of central California),
and National Fuel Gas Company (an integrated gas company with a
number of subsidiaries that are engaged in utility, pipeline and
storage, exploration and production, hub services and natural gas
marketing operations).

^{2/} A service or transportation agreement is a contract between the pipeline operator and natural gas shipper which governs the terms of the transportation service provided by the pipeline operator.

Transactions executed on the System predominately result in the physical movement of natural gas from sellers to buyers. QuickTrade prepares pipeline nominations for each individual subscriber on a net intra-day basis. If a subscriber has contractual obligations to both deliver and receive natural gas at the same delivery point on the same day, QuickTrade will net the delivery and receipt obligations. QuickTrade represents that the netting of an individual subscriber's overlapping delivery and receipt obligations to simplify the delivery process and reduce transaction costs is standard practice in the natural gas cash market as well other cash markets which use pipelines to effect delivery.

Data provided by EEI indicates that during the period July 1, 1995 through September 30, 1995 more than 83 percent of the total volume of natural gas contracted on the Alberta trading system was physically delivered. Furthermore, of the 4,918 transactions executed on the Alberta system during the period January 1, 1994 through August 1, 1995, only 225 transactions (4.57 percent) were fully netted. QuickTrade represents that it does not expect the level of netting on the U.S. trading system to deviate substantially from the levels observed on the Alberta trading system.

Relevant Commission staff is of the opinion that the netting procedures used by QuickTrade mirror the current cash market practices of natural gas and other petroleum product pipeline delivery systems. Moreover, the percentage of netting that has occurred on the Alberta system, and which is expected to occur on the QuickTrade system, is not inconsistent with that which has been observed on other physical pipeline delivery systems.

^{2/} The high incidence of physical delivery differentiates the operation of QuickTrade's electronic market from the operation of a futures market. In futures markets, commercial participants use futures contracts primarily as a hedging mechanism to provide price protection and not as a source of supply of the underlying commodity. By contrast, contracts executed on the System require, and the commercial participants anticipate, the movement of the underlying commodity through normal cash market channels and any netting is incidental to the pipeline delivery mechanism.

^{4/} Full netting takes place only when a subscriber has contractual obligations to both receive and deliver natural gas and such contracts have identical terms as to quantity, delivery start and end times, and delivery point. In such situations, the contractual obligations remain open until the delivery date when the subscriber's delivery and receipt commitments cancel each other out to avoid duplicative deliveries and no gas flows into or out of the subscriber's natural gas account.

As described in more detail below, transactions executed on the System are:

- (1) principal-to-principal transactions, 5/
- (2) between qualified commercial parties,
- (3) establishing binding physical delivery obligations,
- (4) for delivery within customary cash market time frames,
- (5) not collateralized or subject to variation margin payments, 2 and
- (6) are primary obligations of QuickTrade.2/

Purchases or sales of natural gas on the System are principal-to-principal transactions between commercial parties who meet Active-Status criteria and establish firm-delivery commitments that convey the legal right and obligation to transfer natural gas in accordance with the contract's specifications.

Subscribers may enter individualized terms as to price, volume, and delivery start and end dates for each contract. The standard Subscription Agreement executed by each System user provides that title transfers from the seller to QuickTrade at

^{5/} The terms of transactions are individually negotiated between subscribers. Due to the policies of pipeline operators as discussed in footnote 8, <u>infra</u>, the QuickTrade system is structured so that once a transaction has been negotiated, two simultaneous transactions occur, one between the purchaser and QuickTrade and the other one between QuickTrade and the seller. Thus, QuickTrade is market neutral.

^{6/} As discussed below, a subscriber who does not satisfy QuickTrade's credit criteria may be granted access to the System by posting security with QuickTrade. Such subscriber's open positions, however, are not subject to initial or variation margin payments.

^{7/} QuickTrade has primary responsibility for all obligations because of its separate obligations to the buyer and seller under each transaction. However, because of the contracting process required by the System, these obligations are completely offset by the obligations of the other buyer or seller, as the case may be.

the delivery hub. OuickTrade will then immediately transfer title to the buyer.

The financial creditworthiness of each Active-Status Subscriber is examined by QuickTrade prior to gaining access to the System. Active-Status Subscribers with an insufficient credit history or financial condition are granted access to the System only by posting security with QuickTrade. QuickTrade continuously monitors the financial condition of the Active-Status Subscribers by periodically requiring such subscribers to submit financial information and may, in its sole discretion, demand additional security and/or curtail trading activity.

Once a trade has been executed, QuickTrade is liable for the physical component of the transaction. If an Active-Status Subscriber defaults on its delivery/receipt obligation, QuickTrade will remedy the default by either supplying or receiving the natural gas on behalf of the defaulting party. QuickTrade will rely on physical backstopping of supply and/or market from its affiliated companies to ensure that a default does not disrupt the operation of the System.

QuickTrade also is liable for the financial component of each transaction. If an Active-Status Subscriber defaults, QuickTrade will satisfy the defaulting party's financial obligations. QuickTrade has obtained insurance coverage from Trade Indemnity Group PLC ("Trade Indemnity") to protect the financial integrity of the System. Under the terms of the agreement, Trade Indemnity is responsible for insuring 90 percent of each transaction executed on the System, up to each subscriber's predefined credit limit. QuickTrade remains liable for the remaining 10 percent.

Trades executed on the System are individually negotiated transactions between Active-Status Subscribers. The System does not provide for mutualization of loss; System subscribers do not guarantee and are not responsible for the defaults of other subscribers.

A subscriber who fails to perform its contractual obligations is liable to QuickTrade for all costs incurred in

B/ QuickTrade states that pipeline operators have a policy that prohibits a buyer or seller from both contracting individually with the pipeline and contracting through an agent. This policy would hinder the operation of the System since subscribers contract directly with the pipelines for the vast majority of their transactions. QuickTrade has addressed this problem by providing that title passes from seller to QuickTrade with an immediate retransfer to the buyer.

guaranteeing such subscriber's physical and financial obligations. A subscriber who fails to perform its contractual obligations is also assessed an administrative fee equal to the greater of \$5,000 or five percent of the total cost of remedying the breach and may have its access to the System revoked or suspended.

QuickTrade performs administrative and bookkeeping functions on behalf of the subscribers. QuickTrade prepares confirmations for each transaction executed on the System. QuickTrade also prepares monthly invoices detailing each subscriber's transactions executed on the System. Active-Status Subscribers with a net payment due for natural gas shipments received are required to remit payment to QuickTrade by the 25th day of each month. Conversely, Active-Status Subscribers with a net receivable from natural gas shipments receive payment on the 25th day of each month directly from QuickTrade. Subscriber funds are segregated from QuickTrade's operating accounts. QuickTrade represents that these invoicing and payment terms are consistent with gas industry standards between buyers and sellers in the cash market.

As noted above, QuickTrade commenced operation of the System on January 8, 1996. QuickTrade represents that its expansion into the United States market is largely a result of the Federal Energy Regulatory Commission's Order No. 636 which extensively revised the federal sales, transportation, and storage regulations governing the natural gas industry and is intended to facilitate more transparent cash natural gas pricing mechanisms.

The Commission understands that on December 30, 1993, the Alberta Securities Commission issued a temporary Order exempting EEI, its electronic natural gas trading system, and the subscribers, from registration and reporting requirements of the Alberta Securities Act. This Order was subsequently renewed for a two-year period expiring on June 8, 1997, when it will be subject to review by the Alberta Securities Commission upon an application for renewal. The Commission further understands that as a condition of the registration and reporting requirement exemption, EEI has agreed to provide the Alberta Securities Commission with the following information:

^{2/} QuickTrade will assess the factors surrounding a breach before determining if the suspension of trading privileges is warranted.

- Unaudited interim financial statements on a quarterly basis;
- Audited financial statements on an annual basis;
- Notice of any revisions of the Subscription Agreement and gas contract;
- A quarterly summary of trading activity, including:
 - any changes in the number and identity of subscribers,
 - confirmation that each subscriber is in compliance with the credit policy at the end of the last preceding calendar quarter,

- the identity of any subscriber who has been suspended from trading on the EEI system, and the reasons therefor,

- the number of defaults and the actions taken to remedy the defaults, and

- a summary of any investigations performed with respect to the system and/or subscribers.

QuickTrade has represented that it will maintain records comparable to those set forth above and provide such information to the Commission upon request.

Furthermore, to facilitate Commission monitoring QuickTrade agrees to submit reports on an annual basis, commencing with calendar year 1996, to the Commission setting forth the following information:

- A summary of the total number of contracts executed on the System by each subscriber and the total number of transactions fully netted by each subscriber; and
- A summary of the total volume of natural gas contracted on the System by each subscriber and the total volume of natural gas delivered/received by each subscriber.

QuickTrade also represents that it will keep and maintain transaction and financial records and make them available to the Commission and submit data to the Commission promptly upon request and that it will provide information on its operations and the cash market as necessary to the Commission for its monitoring of markets subject to its jurisdiction. In addition, the Commission may request information or reports concerning operation of the System as authorized under various provisions of

the Commodity Exchange Act ("Act") 10/ and Commission regulations.11/

Based upon the foregoing, the OETF will not recommend that the Commission take enforcement actions against BEI, Enerchange, or QuickTrade for failing to obtain designation as a contract market, registering under the Act, or otherwise complying with the Act or Commission regulations in connection with those firms' operation of QuickTrade, an electronic system for trading physical natural gas in the United States.

This letter is based upon the information that has been provided to us, including the data on the netting activity on the Alberta trading system and QuickTrade's representations concerning anticipated netting on the U.S. system. In this regard, QuickTrade represents that it will notify the Commission immediately if it determines that less than 75 percent of the total volume of natural gas contracted through the System, measured on an annual basis, is delivered, and understands that the Commission may consider added terms and conditions in such an event. Furthermore, QuickTrade represents that it will notify the Commission of any applications for trading privileges received from non-commercial entities prior to granting such applicants access to the System. Any different, changed or omitted facts or conditions, including increases in the netting activity, might require us to reach a different conclusion.

The position set forth above is that of the Off-Exchange Task Force only and does not necessarily represent the views of the Commission. Furthermore, the relief granted by this letter is prospective only and should not be construed to limit in any way the Commission's ability to take enforcement action against EEI, Enerchange, or QuickTrade for any past violations of the Act or regulations if the Commission deems such action appropriate.

Andrea M. Corcoran

Pat G. Nicolette

Co-Chairmen

Off-Exchange Task Force

^{10/ 7} U.S.C. § 1 et seq. (1994).

^{11/} Commission regulations are found at 17 C.F.R. Ch. I (1995), as amended by Fed. Reg. 38,146 (July 25, 1995).